IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1942

No. 189

FRANK A. BARLOW, TRUSTEE OF THE ESTATE OF THE LIBERTY POSTER COMPANY, A CORPORATION, BANKRUPT, *Petitioner,*

vs.

W. P. BUDGE, CLAIMANT,

Respondent.

PETITIONER'S REPLY BRIEF

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POSITION OF RESPONDENT

Respondent claims the issue before the Bankruptcy Court was whether his claim for money loaned in good faith to and used by the corporation must be subordinated to the claims of the general creditors which arose thereafter. This position ignores the duty and obligation that respondent owed to the creditors whose claims were contracted after July 1, 1937, and after respondent was unwilling to make further contributions. Respondent relies on two points: One, that the contributions constituted a loan, and the other, good faith.

LOAN

Whether the contributions by respondent constituted a loan, or amounted to a contribution to capital is not decisive of this case, because of the duty the respondent owed to the creditors whose claims were contracted after July, 1937. At the time that the contributions were made, the capital was inadequate and the corporation could not then have borrowed from informed outside sources. The contributions were made to keep the business going. If the business had been liquidated at that time, the debts of the present general creditors would never have been contracted. The record required a disallowance of the claim of respondent because the contributions were to capital and not a loan. The most that can be said for respondent is that when he made the contributions he intended, at some future time, to make withdrawals from the corporation, as he had previously done. That is, as between himself, Rose and Morrissey, he, like a partner, or joint venturer, would withdraw such contributions. The time never came when he could make such withdrawals without causing the liquidation of the corporation. The respondent and Rose treated the corporate business as their own enterprise. This alone was sufficient to require the subordination of respondent's claim to that of the creditors whose debts were contracted after July 1, 1937. *Pepper vs. Litton*, 308 U. S. 295, 310.

GOOD FAITH

There was no admission of respondent's good faith. The portion of the Record that respondent refers to appears in the referee's summary and was not sustained by what actually took place before the referee. At page 39 of the Record appears the whole of what took place in this connection and is as follows:

"The Referee: Now, is there any question of facts here involved—that Mr. Budge actually, in the manner indicated, contributed or paid over these amounts?

Mr. Culhane: I don't think there is any question but what he turned the money over to the corporation.

The Referee: And that it was used for corporate purposes?

Mr. Culhane: I think it was.

The Referee: Then practically the only question here is, the question of law as to whether on the facts as presented, there was a contribution of capital, not permitting him to share with the general unsecured creditors, or whether he shares with them as a debtor; is that it?

(Argument by counsel.)

The Referee: Both sides have tentatively rested in the Budge matter.

Mr. Culhane: That is right."

Considered as a loan the Record shows not only bad faith but actual fraud as to creditors whose claims were contracted after July 1, 1937. By that date, as a result of continual losses over a term of years and very substantial withdrawals from the corporate capital, even after the corporate capital had been depleted (R. 18, 21), the respondent was unwilling to make any further contributions. However, he and Rose, after that date, contracted substantial debts with general creditors, still unpaid.

CREDITORS MISLED

Respondent urges that creditors were not misled by what he did. The evidence as to whether this is true or false is not in dispute. The Circuit Court of Appeals said: That the advances made by respondent were made to enable the corporation to meet pressing obligations and remain in business (R. 87). Respondent testified that the contributions were made to prevent the bank account from being overdrawn (R. 24-26) and save the corporation from financial

difficulty (R. 38). The threatened financial difficulty was occasioned by losses over a period of years and unauthorized withdrawals (R. 18, 21). The capital stock had been substantially depleted by July 1, 1937, if respondent's claim was then an actual debt of the corporation and not a capital contribution (R. 21). To all outward appearances on and after July 1, 1937, those selling to the corporation were justified in believing that the corporate capital had not been depleted and in extending credit accordingly. As to creditors' justification for relying on professed capital in extending credit, the Supreme Court of Minnesota in an opinion by Justice Mitchell in *Hospes vs. Northwestern Manufacturing & Car Co.*, 48 Minn. 192, 50 N. W. 1117, 15 L. R. A. 470, 31 Am. St. Rep. 637, cited in the Petition for Re-hearing herein, in a case by creditors to compel holders to pay for "bonus" stock, said in part:

> "It is urged, however, that, if fraud be the basis of stockholders' liability in such cases, the creditor should affirmatively allege that he believed that the 'bonus stock' had been paid for, and represented so much actual capital, and that he gave credit to the incorporation on the faith of it; and it is also argued that, while there may be a presumption to that effect in the case of a subsequent creditor, this is a mere presumption of fact, and that in pleadings no presumption of facts are indulged in. This position is very plausible, and at first sight would seem to have much force; but we think it is unsound. Certainly, any such rule of pleading or proof would work very inequitably in practice. Inasmuch as the capital of a corporation is the basis of its credit, its financial standing and reputation in the community has its source in, and is founded upon, the amount of its professed and supposed capital, and everyone who deals with it does so upon the faith of that standing and reputation, although, as a matter of fact, he may have no personal knowledge of the amount of its professed capital, and in a majority of cases knows nothing about the shares of stock held by any particular stockholder, or, if so, what was paid for them."

CONTRIBUTIONS WERE MADE BEFORE JULY 1, 1937

Respondent relies upon the language of the Circuit Court of Appeals that: "The advances were made before the creditors, to whose claims it is now contended Budge's claim should be subordinated, had become creditors" (R. 86-87). This statement shows that the Circuit Court of Appeals did not consider the fiduciary obligation that respondent owed to creditors whose debts were contracted after July 1, 1937. This question is covered in our former brief in connection with Reason 2. The case at bar falls within a class of corporate cases, sometimes called "claims cases." The decisions of the courts in such cases are in a state of some confusion and conflict. In *Deep Rock, Pepper vs. Litton* and *Sampsell* cases, we submit that this court, for the guidance of Courts of Bankruptcy, pointed out basic equitable principles applicable in cases like the case at bar. With all due respect for the Honorable Judges of the Circuit Court of Appeals for the Eighth Circuit, the equitable principles, above referred to, were not applied in the case at bar. On the contrary, the judgment of that court conflicts with these equitable principles and unless such judgment is reviewed by this court, it and the opinion of the Circuit Court of Appeals, will tend to cause further confusion and conflict in the decision of Courts of Bankruptcy as to the application of the above mentioned equitable principles in cases similar to the case at bar.

Respectfully submitted,

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